Effective Date: September 19, 1997

COORDINATED ISSUE
PETROLEUM INDUSTRY
CAPITALIZATION OF DELAY RENTALS

ISSUE

Are delay rentals paid or incurred under an oil and gas lease subject to capitalization under I.R.C. §263A as costs of producing property?

CONCLUSION

For tax years beginning after December 31, 1993, delay rentals incurred under an oil and gas lease are required to be capitalized to the depletable basis of the property to which they relate pursuant to section 263A if the lease is held for development or if development of the lease is reasonably likely at some future date. A taxpayer who performs geological and geophysical surveys (G&G) on acquired leaseholds or files a plan of development with an appropriate governmental agency has demonstrated an unequivocal intention to develop the leasehold in the future. Even in the absence of such unequivocal steps, it can be presumed that taxpayers in the business of producing oil and gas acquire leasehold interests with the intent to develop them. Thus, it is assumed that development of an acquired leasehold will ordinarily occur. Therefore, unless the taxpayer can establish by credible evidence that the leasehold was acquired for some reason other than development, the taxpayer must capitalize the delay rentals incurred with respect to that leasehold.

For tax years beginning before January 1, 1994, a taxpayer must take a "reasonable position" on its federal income tax return when applying section 263A to delay rentals. Some examples of reasonable positions are to capitalize delay rentals on leaseholds that the taxpayer had a plan to produce, (i.e., to develop), to capitalize delay rentals on all leaseholds that the taxpayer acquired and thereafter gathered G&G data on, to capitalize delay rentals on leaseholds in amounts equal to the taxpayer's historical percentage of actual leasehold development, or to capitalize all of the delay rentals that were incurred by the taxpayer. In any event, capitalization of zero delay rentals is not a reasonable position.

DISCUSSION

Petroleum companies acquire leasehold mineral interests in the ordinary course of their businesses. At the time of the acquisition, the lessee/sublessee pays and capitalizes the leasehold bonus paid to the property or mineral owner. For any period that the lessee fails to drill on the leasehold, the lessee must pay a delay rental to the property or mineral owner.

Treas. Reg. §1.612-3(c), which predates the enactment of section 263A, provides that delay rentals are in the nature of rent and that the payor may elect to deduct delay rentals as an expense or, under section 266 and the regulations thereunder, charge delay rentals to a depletable capital account. Section 261 provides that in computing taxable income no deductions shall, in any case, be allowed in respect of the items specified in sections 261 through 280H. Accordingly, delay rentals may not be deducted under Treas. Reg. §1.612-3(c)(2) if they are required to be capitalized under another Code section, such as section 263A.

Section 263A, its legislative history and the temporary regulations all indicate that carrying charges, such as delay rentals, are subject to capitalization under section 263A. Accordingly, it is not reasonable for taxpayers/lessees to rely on Treas. Reg. §1.612-3(c)(2) as authority to deduct all dely rentals in the year paid or incurred.

Section 263A requires the capitalization of all direct costs, and an allocable portion of indirect costs, of property produced by a taxpayer. Section 263A(c)(3) provides an exception for costs allowable as a deduction under sections 263(c), 263(i), 291(b)(2), 616, or 617. Delay rentals are not allowable as a deduction under any of these sections. Thus, delay rentals must be capitalized if they relate to property "produced" by the taxpayer.

For purposes of section 263A, the term " produce" includes "construct, build, install, manufacture, develop, or improve." See section 263A (g)(1). Under the final regulations, production of a property begins when physical production activities are undertaken. See Treas. Reg. §1.263A-13(b)(1)(i). Thus, "production" of an oil and gas lease under section 263A occurs long before and regardless of whether a lease actually produces a flow of hydrocarbons.

Treas. Reg. §1.263A-2(a)(3)(ii) provides the capitalization rules for pre-production costs. If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely the property will be subsequently developed. See Von-Lusk v. Commissioner, 104 T.C. 8 (1995), on appeal to the 9th Circuit.

In the case of an acquired oil and gas leasehold, the lessee demonstrates an intent to produce such leasehold by acquisition and confirms the intent to produce by actually producing (developing) the leasehold. Specifically, when G&G is run on a leasehold and analyzed for potential hydrocarbons, the lessee has taken unequivocal steps that ordinarily will lead to the production of oil and/or gas if such minerals are present in commercially extractable quantities. Similarly, the filing of the development plan for the leasehold with the Mineral Management Service (MMS) or other appropriate governmental agency is an unequivocal step that shows the lessee's progression toward the production of oil and/or gas and is also considered a pre-production activity. Such pre-production activities reflect the taxpayer's intent to produce (develop) the leasehold even though the leasehold may be abandoned at a later date. Even in the absence of such unequivocal steps, it can be presumed that taxpayers in the business of producing oil and gas acquire leasehold interests with the intent to develop them. Thus, it is assumed that development of the acquired leaseholds will ordinarily occur. Therefore, unless the taxpayer can establish by credible evidence that the leasehold was acquired for some reason other than development, the taxpayer must capitalize the delay rentals incurred with respect to that leasehold.

For tax years prior to the effective date of the final section 263A regulations, taxpayers must take reasonable positions on their federal income tax returns with respect to pre-production costs. A reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A that were applicable in years beginning before January 1, 1994. See Treas. Reg.§1.263A-1(a)(2)(ii).

It is not reasonable for taxpayers to take the position that all delay rentals are currently deductible in tax years which were before the effective date of the pre-production rule in the final regulations. Rather, delay rentals should have been treated as any other type of carrying cost subject to capitalization under section 263A, and some portion of the delay rentals actually incurred must have been capitalized.

The delay rentals capitalized by a taxpayer/lessee must be included in the depletable basis of the property for which they are incurred. If the taxpayer/lessee abandons the lease, the adjusted basis of the property may be deducted as provided in section 165.

CHANGE IN METHOD OF ACCOUNTING

A change from deducting delay rentals in the year paid or incurred to capitalizing the delay rentals to the depletable basis of the property to which they relate, pursuant to section 263A, is a change in method of accounting to which the provisions of sections 446 and 481 apply. The adjustment required under section 481(a) to take into account amounts that would be duplicated or omitted solely by reason of the change in method of accounting is computed as of the beginning of the year of the change in method of accounting. See section 2.10 of Rev. Proc. 97-27, I.R.B. 1997-21 (May 27, 1997), for the terms and conditions ordinarily applicable for a change in method of accounting made by a District Director.